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Report to the Honorable William J. Coyne, Ranking Minority Member, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

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INTERNAL REVENUE SERVICE

Efforts to Identify and Combat Abusive Tax Schemes Have Increased, but Challenges Remain

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Abbreviations

CI	Criminal Investigation
DOJ	Department of Justice
FBI	Federal Bureau of Investigation
FinCEN	Financial Crimes Enforcement Network
FTC	Federal Trade Commission
IRS	Internal Revenue Service
QRDT	Questionable Refund Detection Teams
QRP	Questionable Refund Program
PIO	public information officers
SEC	Securities and Exchange Commission
SB/SE	Small Business and Self-Employed
USAO	United States Attorneys Offices
TIGTA	Treasury Inspector General for Tax Administration
W&I	Wage and Investment

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

May 22, 2002

The Honorable William J. Coyne
Ranking Minority Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Coyne:

In early 2001, several congressional hearings and related press reports raised the issue of increased promotion and use of various forms of organized tax evasion such as abusive tax schemes. More recently, in April 2002, the Commissioner of Internal Revenue (IRS) testified that identifying and combating actively promoted tax schemes are IRS's highest compliance priorities.[1] These abusive tax schemes represent a significant loss of tax revenue to the Treasury. Furthermore, tax schemes give the appearance that the tax system is unfair, which in turn can undermine taxpayer confidence in the tax system.

In recognizing the apparent proliferation of abusive tax schemes, you asked us to determine (1) the types of activities IRS considers to be organized tax evasion, (2) the extent of such activities, (3) the actions IRS takes to identify and deal with such tax evasion, and (4) how IRS coordinates its actions with other relevant federal agencies.

To respond to your request, we interviewed IRS and other appropriate agencies' officials and obtained documents related to the extent of abusive schemes and IRS's efforts to combat them. Our review focused primarily on abusive tax schemes that are used by individuals rather than those used by corporations. Our scope and methodology is discussed in more detail in a separate section of this report.

Results in Brief

IRS characterizes an abusive tax scheme as any plan or arrangement created and used to obtain tax benefits not allowable by law. As such,

[1] See testimony by the Commissioner of Internal Revenue before the Senate Committee on Finance, April 11, 2002.

schemes can be based on improper use of domestic and foreign trusts, inflated business expenses and deductions, falsely claimed tax credits and refunds, and various anti-tax arguments. According to IRS, abusive tax schemes fall into four categories: frivolous returns, frivolous refunds, abusive domestic trusts, and offshore schemes.

IRS estimates the potential revenue loss from abusive tax schemes to be in the tens of billions of dollars annually. According to an IRS official, developing accurate estimates in this noncompliance area is difficult. For example, taxpayers using domestic trusts and offshore schemes may file tax returns, but those returns alone seldom provide enough information for IRS to determine whether an abusive tax scheme was used. IRS often bases its estimates in this area on limited numbers of cases that have been examined or investigated, on intelligence obtained in the course of normal tax administration and criminal investigation activities, and on IRS officials' professional judgments. Although abusive tax schemes are used in a small portion of the approximately 130 million individual income tax returns that yield about a trillion dollars in revenue, the estimated extent of tax schemes is nevertheless significant. In February 2002, IRS estimated that about 740,000 taxpayers used abusive tax schemes in tax-year 2000. IRS detected approximately $5 billion in improper tax avoidance or tax credit and refunds claims, and it estimated that another $20 billion to $40 billion in taxes had not been identified and addressed related to offshore schemes. Subsequent to these estimates, IRS increased the number of taxpayers believed to be involved in abusive offshore activities, which potentially could increase the amount of revenue lost. IRS is increasing its estimates primarily because the numbers of taxpayers with offshore accounts is greater than earlier believed. In contrast to abusive domestic trusts and offshore activities, frivolous return and frivolous refund estimates are based in large part on returns and refund claims that IRS identified while processing tax returns. IRS addressed these tax schemes by pulling the associated returns and notifying the taxpayers that their returns contain a frivolous position and requesting that a corrected return be submitted.

According to IRS's Commissioner, identifying and combating abusive tax schemes are the highest compliance priorities within IRS. IRS identifies and examines abusive tax scheme promoters and participants primarily through efforts by its Small Business and Self-Employed (SB/SE) division and Criminal Investigation (CI). In fiscal year 2000, IRS created a program that focuses on false and frivolous schemes. IRS has also created new offices that focus exclusively on abusive tax schemes that use legal structures like domestic and offshore trusts and partnerships. Recent data

suggest that IRS's efforts have contributed to increases in convictions of persons who engage in promoting schemes as well as those who participate in them. IRS also is educating the public about abusive tax schemes and publicizing the results of its enforcement activities related to abusive tax schemes. In the process of improving its compliance and enforcement efforts, IRS has also recognized that its resources are stretched and these multiple efforts require organizational coordination. IRS recently reorganized its compliance organization in an attempt to combat abusive tax schemes more effectively.

IRS coordinates with federal agencies to identify, monitor, and prosecute promoters and participants in abusive tax schemes. These activities range from sharing information and detection techniques with agencies such as the Securities and Exchange Commission (SEC) and the Federal Trade Commission (FTC) to assisting in the prosecution of fraud related cases with the Department of Justice (DOJ). IRS participates in work groups that share information, skills, and procedures. These work groups discuss procedures for combating fraud on the Internet and the use of civil injunctions against promoters of abusive tax schemes.

In a May 16, 2002 letter, the IRS Commissioner agreed with the conclusions in this report. (See agency comments and our evaluation section and the appendix.)

Background

According to IRS, during the mid- to late-1990s, abusive tax schemes reemerged across the country after last peaking in the 1980s. As previously mentioned, during hearings held in 2001, several witnesses testified about the increased promotion and use of such tax schemes. Marketing of these schemes by promoters through the use of the Internet was mentioned as giving them a thriving new life by making them available to millions of taxpayers easily and inexpensively.

Schemes run from simple to very complex, from clearly illegal to those carefully constructed to disguise the illegality of the scheme. Furthermore, users of schemes can range from those believing their position is correct to those who knowingly and willfully file incorrect tax returns. Some schemes are created by tax professionals such as accountants, lawyers, and paid tax preparers, and by groups and individuals. Tax schemes are offered to taxpayers using various means, including conferences or seminars, publications, advertisements, and the Internet. Others are promoted by word-of-mouth.

Scope and Methodology

To determine the types of activities IRS considers to be abusive tax schemes, we interviewed cognizant IRS officials from SB/SE, who have specialized expertise in abusive tax schemes issues. In addition, we obtained pertinent IRS documents related to abusive tax scheme activities, including information from IRS's CI Internet site and the Small Business and Self-Employed Strategic Assessment Report.

To determine the extent or magnitude of the abusive tax scheme issue, we obtained and reviewed estimates from IRS's SB/SE division for the identified abusive tax scheme categories—Frivolous Returns, Frivolous Refunds, Abusive Domestic Trusts, and Offshore Schemes. The estimates include the number of taxpayers involved in each scheme category; in conjunction, the estimates report the amount of tax revenue protected by the identification of frivolous returns and refunds and the amount of potential revenue lost in abusive trusts and offshore schemes.

To determine the actions IRS takes to identify and deal with abusive tax scheme activities, we interviewed officials from IRS's SB/SE division and CI. Additionally, we obtained and reviewed relevant documents related to the organizations and programs involved in addressing IRS's abusive tax scheme activities.

To determine how IRS coordinates its actions with other federal agencies, we interviewed cognizant officials within CI and at several federal agencies. The federal officials we interviewed were from the FTC, the SEC, the Financial Crimes Enforcement Network (FinCEN), DOJ, the Federal Bureau of Investigation (FBI), and the Executive Office for United States Attorneys. You also expressed interest in IRS's coordination efforts with state agencies. We are not reporting on this topic because many of the states contacted did not consider abusive tax schemes to be a major issue for them. Due to their limited resources, states focused on noncompliance issues that were more directly related to the types of taxes they collect such as sales and employment taxes.

This review primarily focuses on abusive tax schemes that are used by individuals rather than those that are used by corporations. Although some overlap may exist between the schemes used by individuals and corporations, our focus was on schemes that are generally used by individuals to inappropriately reduce the taxes they owe or to generate refunds to which they are not properly entitled.

We performed this work from July 2001 through April 2002 in accordance with generally accepted government auditing standards.

Four Categories of Abusive Tax Schemes

Abusive tax schemes, which are generally used by individuals, fall into four major categories. For the first two, frivolous returns and frivolous refunds, taxpayers submit a tax return that either states an argument that IRS can readily identify as frivolous or a tax return with characteristics IRS has identified as reflecting a frivolous argument. For the other two, abusive domestic trusts and offshore schemes, taxpayers' returns are less likely to reveal the use of a clearly abusive tax scheme.

Frivolous Returns

These schemes generally use any number of anti-tax arguments to incorrectly claim that income is exempt from taxation or that IRS otherwise lacks authority needed to tax income. These arguments have been well litigated in the courts and consistently ruled to be without merit. Examples include the following:

- Form 2555 Scheme: In this scheme, individuals file an IRS Form 2555, Foreign Earned Income, and claim that their income was not earned within the United States. This is also known as the "not a citizen" argument in which taxpayers file returns stating they are citizens of the "Republic of [any state]" and not citizens of the United States, and thus, their income is not taxable.
- Section 861: Individuals using this scheme claim that under Internal Revenue Code Section 861 income tax must only be paid on foreign income and, therefore, their income is not subject to tax or withholding. In these cases, taxpayers file a tax return and show a zero amount for wages. According to IRS, this argument has spread to some employers who are using it to avoid withholding and paying payroll-type taxes on their employees.

Frivolous Refunds

According to IRS, credit and refund abusive tax schemes are designed to substantially reduce taxes or create a refund for the taxpayer, generally by claiming eligibility for a credit that does not exist or to which the taxpayer is not properly entitled. One such scheme that has received much attention is the Slavery Reparation Refund scheme. According to IRS, promoters circulate or publish information claiming African Americans are eligible for slavery reparations. Taxpayers claiming this credit generally enter a significant amount on their tax return as a credit that results in a taxpayer realizing a refund if not detected by IRS.

Abusive Domestic Trusts

A trust is a legitimate form of ownership that completely separates asset responsibility and control from the benefits of ownership. As such, trusts

are commonly used in matters such as estate planning. An abusive domestic trust scheme usually involves a taxpayer creating a trust that does not meet the Internal Revenue Code requirements that the assets and income of the trust not be subject to the control of the taxpayer. Once such an improper trust is established and the taxpayer has transferred business or personal assets to it, the scheme may involve further abuses, such as offsetting income of the trust by overstating its business expenses or including the taxpayer's personal expenses—like a home mortgage—as an expense of the trust. The taxpayer will often use multiple entities such as partnerships, limited liability companies, or secondary level trusts that can be tiered or layered to mask the taxpayer's continued ownership or control of the trust's income or assets.

Offshore Schemes

Abuses that involve foreign locations can take a wide array of forms and attempt to use a number of techniques to improperly avoid paying taxes. One common technique is simply to use foreign locations to add another level of complexity in obscuring the true ownership of assets or income and thus obfuscating whether taxes are owed and by whom. Use of foreign locations, for instance, can be combined with use of trusts to make unraveling the true ownership of assets and income more difficult for IRS. According to IRS, criminals long have used offshore schemes to disguise the true nature of their enterprise and the resulting income. Promoters of abusive tax schemes have, according to IRS, increasingly devised schemes that in some fashion involve transferring income or title to assets to foreign locations. Often, foreign locations are selected because they are tax havens with little or no taxation on income in their jurisdiction, have privacy rules that help schemers hide what they are doing, or have other characteristics favorable to carrying out the schemes. According to IRS, once such transfers are established, income is often repatriated back to the U.S. owners through loans, credit cards, or debit cards. By using complex transactions and multiple entities, the individuals using these schemes attempt to hide their income and avoid potential tax liabilities.

Evidence of Rapid Tax Scheme Growth

Of the approximately 130 million individual income tax returns filed annually yielding about a trillion dollars in revenue, approximately 740,000 taxpayers used abusive tax schemes in tax-year 2000 according to IRS estimates. According to IRS's fiscal year 2003-2004 Small Business and

Self-Employed (SB/SE) Division Strategic Assessment Report,[2] abusive tax schemes represent a rapidly growing risk to the tax base. IRS estimates the potential revenue loss from these schemes to be in the tens of billions of dollars annually. According to an IRS official, to make accurate estimates in this area of noncompliance is difficult. Despite the difficulties in accurately estimating the significance of abusive tax schemes, IRS provided us with estimates in four major scheme areas— Frivolous Returns, Frivolous Refunds, Abusive Domestic Trusts, and Offshore Schemes. According to IRS, its estimates were made in February 2002 and were derived from information gathered during tax return processing and examination activities and from the work of IRS's Criminal Investigation (CI), the law enforcement arm of IRS. According to an IRS official, these estimates were derived from tax-year 2000 information, the last full year for which data were available. IRS's estimates are as follows:

- Frivolous returns: about 62,000 taxpayers with associated tax amounts approximating $1.8 billion.
- Frivolous refunds: about 105,000 taxpayers with associated tax amounts approximating $3.1 billion.
- Abusive domestic trusts: about 65,000 taxpayers with tax losses approximating $2.9 billion.
- Offshore schemes: about 505,000 taxpayers with tax losses ranging from $20 billion to $40 billion.

IRS's estimates for the numbers of taxpayers and taxes in connection with frivolous returns and frivolous refunds, although not precise, likely have less uncertainty than its estimates of the numbers of taxpayers and taxes at risk in connection with abusive domestic trusts and offshore schemes. IRS's estimates for frivolous returns and frivolous refunds are based in large part on returns and refund claims that IRS has identified while processing tax returns and has addressed by pulling the associated returns and notifying the taxpayers that their returns contained a frivolous position that needed to be corrected by submitting a revised return. Thus, in these cases, IRS has a fairly direct basis for counting the number of taxpayers involved and the amount of tax involved. Furthermore, because

[2] The FY 2003-2004 SB/SE Strategic Assessment Report (Mar. 1, 2002) provides IRS assessment of critical trends, issues, and problems facing the SB/SE taxpayer customer segment.

IRS has pulled these returns from processing, in general, improper refund claims have not been paid out, and IRS is pursuing collection of the proper amount of tax when taxpayers have failed to pay the full amount owed.[3]

In contrast, although taxpayers using domestic trusts and offshore schemes may file tax returns, those returns alone seldom provide enough information for IRS to determine whether an abusive scheme was used. Therefore, IRS's estimates of the numbers of taxpayers and the taxes at risk for the domestic trust and offshore scheme categories generally rely on limited numbers of cases that have been examined or investigated, on intelligence obtained in the course of normal tax administration and CI activities, and on IRS officials' professional judgments.

Recognizing that offshore transactions are a significant factor in offshore schemes, IRS has been taking steps concerning the use of credit/debit cards issued by offshore banks to U.S. taxpayers. Although having an offshore credit card is not illegal, IRS believes that some U.S. taxpayers are using such cards to evade U.S. taxes. In October 2000, a federal judge authorized IRS to serve "John Doe" summonses on American Express and MasterCard to obtain limited information on U.S. taxpayers holding credit cards issued by banks in several tax-haven countries.

On the basis of information received from MasterCard, IRS identified about 235,000 accounts issued through 28 banks located in 3 countries. IRS's ongoing analysis of these data leads it to estimate that between 60,000 and 130,000 U.S. customers are associated with these 235,000 accounts. In part because MasterCard is estimated to have about 30 percent of this market, IRS estimates that there could be 1 to 2 million U.S. citizens with credit/debit cards issued by offshore banks. However, this is a very preliminary estimate. IRS officials believe this estimate may be reduced because, among other things, a portion of these accounts may not be associated with abusive tax schemes. By comparison, only about 117,000 individual taxpayers indicated that they had offshore bank accounts in tax-year 1999. On March 25, 2002, IRS petitioned for permission to serve a summons on VISA International, seeking records on transactions using cards issued by banks in over 30 tax-haven countries.

[3] IRS is not able to detect and stop every frivolous refund scheme. For example, the Treasury Inspector General for Tax Administration (TIGTA) estimated that about $31 million in refunds was sent to taxpayers who claimed reparations credits in tax-year 1999 and in tax-year 2000 returns that were processed from mid-February to mid-April of 2001. IRS has subsequently taken action to recover the funds.

According to an IRS official, a judge granted the summons on March 27, 2002. In May 2002, IRS is scheduled to meet with Visa International to discuss delivery of the information requested in the summons.

In addition, on April 24, 2002, the Treasury Department's FinCEN published an interim final rule to define and provide guidance to operators of credit card systems concerning a provision in the Bank Secrecy Act that requires them to establish anti-money laundering programs. Part of the justification for the rule was the potential for utilizing a credit card system to access in the United States funds located in foreign financial institutions. The successful "John Doe" summonses filed against MasterCard and American Express by IRS were cited by FinCEN as support for publishing the interim rule.

The Treasury Department is concerned that foreign financial institutions located in tax-haven countries are being used to violate and/or evade domestic tax requirements, among other things. Recognizing that, the Secretary of the Treasury submitted a report to Congress on April 26, 2002, proposing several actions to improve compliance regarding foreign bank and financial accounts. These actions are geared to improving reporting, compliance, and enforcement efforts related to U.S. citizens and residents transacting business with foreign financial institutions.

The estimates of the number of individuals and dollar consequences associated with offshore credit/debit card schemes are very uncertain at this time. Nevertheless, IRS's February 2002 estimate of $20 billion to $40 billion in tax dollars at risk from offshore schemes may grow as IRS learns more about the extent of the problem.

Expanded IRS Efforts to Identify and Control Tax Schemes

No one individual or office could provide an agencywide perspective on IRS's strategy, goals, objectives, performance measures, or program results, for its efforts to address abusive tax schemes. Consequently, a clear and consistent picture of IRS's efforts was difficult to obtain. Available information indicates that IRS began increasing its efforts to combat abusive schemes over the past 2 or 3 years, continued to do so in 2001, and plans further future efforts. Limited data also suggest that these enhanced efforts have helped IRS convict more promoters and users of abusive schemes over the past 3 years. IRS has also increased its education and publicity as a way to deter and control the use of abusive tax schemes.

Organizationally, IRS identifies and deals with schemes in two primary ways—during its processing and examination of tax returns (compliance and enforcement) and through the work of CI. Therefore, most of IRS's programs to address abusive schemes are the responsibility of IRS's SB/SE division and CI.

Compliance and Enforcement Efforts

IRS has taken a number of steps to enhance its compliance and enforcement efforts—its audit and other civil enforcement activities—that focus on abusive tax schemes. In the past year, for example, IRS has increased staff years devoted to examining abusive tax scheme promoters, decided to assign and train about 50 more agents to promoter examinations, and laid plans for assigning 200 or more additional staff to reviewing abusive tax schemes and offshore compliance schemes. Furthermore, IRS has created an organization that initially will focus on developing leads and cases related to abusive scheme promoters and that will monitor abusive promoter web sites. IRS has also recognized that its resources are stretched to improve compliance and enforcement efforts and these multiple efforts require organizational coordination. IRS identifies many abusive tax schemes during its normal tax return processing and examination activities. For example, when tax returns initially are processed either manually or by computers, processes are in place to detect apparent frivolous returns or returns reflecting improper refunds. In these cases, the returns are pulled from processing to be forwarded to a unit that specializes in addressing these types of returns. Both the Wage and Investment (W&I) and SB/SE divisions in IRS process taxpayers' tax returns and both have responsibilities for identifying tax returns that may involve abusive tax schemes.

Three principal SB/SE division efforts focusing on or related to abusive tax schemes are

- the Frivolous Return Program,
- the Office of Flow-Through Entities and Abusive Tax Schemes, and
- the National Fraud Program.

Frivolous Return Program

The Frivolous Return Program identifies the tax returns of individuals who assert unfounded legal or constitutional arguments and refuse to pay their taxes or to file a proper tax return. The program also identifies returns claiming frivolous refunds, such as those involving slavery reparations. Generally, IRS provides guidance to those who process tax returns to

identify the characteristics of returns claiming such frivolous arguments or refunds. IRS also has programmed its computers to do so. The Treasury Inspector General for Tax Administration (TIGTA) helped IRS develop software programs to identify slavery reparation schemes. Since both W&I and SB/SE staff process tax returns, both divisions are involved in identifying such returns.

Once identified, the returns are pulled out of the tax return processing stream and forwarded to the Frivolous Return Program unit where they are to be resolved with the taxpayer. The program was consolidated in January 2001, at the Ogden, Utah, Compliance Services Center. The compliance center staff enters information about each case into a database and assigns 1 of 31 different codes identifying the frivolous argument or refund being claimed by the taxpayer. Then, a notice requesting taxpayers to file a proper tax return is to be sent advising them that IRS has judged their tax return to include an argument that is without legal merit or a credit or tax refund to which they are not entitled.

IRS officials state that the number of staff assigned to the Frivolous Return Program unit in Ogden grew from 18 employees in September 2000 to 45 employees in September 2001. Some of this increase may not reflect a net IRS-wide increase in full-time equivalents (FTE) for frivolous returns since the increase has, in part, been due to centralizing efforts in Ogden from other IRS locations. IRS officials expect to assign more employees to this program in fiscal year 2003.

Office of Flow-Through Entities and Abusive Tax Schemes

The Office of Flow-Through Entities and Abusive Tax Schemes became operational in January 2000.[4] Flow-through entities include domestic trusts and offshore trusts and partnerships. These are flow-through entities because their income “flows through” to their partners or other beneficiaries, where it is subject to taxation. The office was created to organize IRS’s efforts in addressing abusive tax schemes, particularly trusts, and to identify their promoters and sellers. The unit’s goals are (1) to catalog and profile schemes and trends, (2) direct compliance resources to examine schemes and promoters or refer tax scheme promoters and participants for criminal prosecution, (3) increase employee knowledge

[4] As part of reorganization within SB/SE, the responsibilities of the Flow-Through Entities and Abusive Tax Schemes office were undergoing change in April 2002. We discuss these changes later in the report.

and skills related to abusive tax scheme issues, and (4) enhance coordination within IRS on issues related to abusive tax schemes.

IRS expects to assign and train about 50 revenue agents this fiscal year to focus mainly on promoters of abusive tax schemes. The agents are to undergo training during the summer of 2002 and to begin examining cases by the fall of 2002. According to IRS, the number of abusive promoter leads increased from 25 in March 2001 to 155 in February 2002. In addition, the number of abusive promoter cases approved for further examinations has increased from 17 cases to 94 cases during the same period. The time spent on these cases is also increasing. IRS also reports that time spent on promoter examinations for fiscal year 2002 is expected to be 12.1 staff years, which is up from 4.4 and 1.2 staff years in fiscal year 2001 and fiscal year 2000, respectively.

Furthermore, IRS plans additional expansion of its abusive tax scheme compliance efforts. For example, IRS expects to develop units that will include 8 to 10 agents in each of 15 locations. These units will address abusive tax schemes and flow-through entities. In addition, given the growing significance of the offshore credit/debit card schemes, IRS plans to create four special enforcement groups. Each group will be staffed by approximately 8 agents and will concentrate on these offshore schemes. This growth in staffing reflects IRS's increased priority for these schemes. IRS officials expect that the agents assigned to these units will be redirected largely from other compliance areas.

*Schedule K-1 Transcription and Matchin*g. In the spring of 2001, the transcription of Schedule K-1 information became a major responsibility of the Office of Flow-Through Entities and Abusive Tax Schemes.[5] According to IRS, information provided on Schedule K-1s is important for determining whether recipients of flow-through income have properly reported that income on their tax returns. IRS can use transcribed data for information matching to determine whether proper reporting of income occurred.

IRS believes that flow-through entities such as trusts and partnerships are increasingly being used in abusive tax schemes. IRS can also use these K-1

[5] The schedule K-1 is an information return that flow-through entities send to partners and beneficiaries with a copy also being provided to IRS. The schedule K-1 provides information on income distributed to partners and beneficiaries. Transcription is the process of taking paper K-1's and inputting them into an electronic format.

data in its return examination and tax collection activities to help identify abusive tax schemes.

Tax-year 1995 marked the last year that Schedule K-1 information was transcribed by IRS. From 1990 through 1995, IRS transcribed approximately 5 percent to 12 percent of the Schedule K-1s received. After 1995, IRS did not transcribe Schedule K-1 information submitted with paper returns nor did it match the income information contained on the schedules with the information presented on individual beneficiaries' or partners' tax returns. IRS again started to transcribe tax-year 2000 K-1 information during the spring of 2001 and completed the process in December 2001. IRS officials told us that the matching of the K-1 information against individual tax returns was to begin in March 2002.

IRS cites several reasons for reinstating its transcription and matching of Schedule K-1s. First, IRS has observed a significant increase in flow-through entities. The number of tax returns filed by trusts, partnerships, and S-corporations has increased by 12 percent, 33 percent, and 35 percent, respectively, over the 6-year period from fiscal years 1995 through 2000. IRS also estimates an overall increase of nearly 2 million such returns by 2009. Second, based on a small study, in January 2002, IRS estimated that between 6 percent and 15 percent of total flow-through income would not be reported on tax-year 2001 returns. IRS estimates that income of about $1 trillion was distributed to taxpayers from flow-through entities for tax-year 2000. Third, IRS expects its Schedule K-1 matching program not only to identify underreporting or nonreporting of income but also to improve taxpayer compliance. Transcription and matching of Schedule K-1 data are expected to increase accurate reporting of trust income on future tax returns just as matching of wage, interest, and other types of income has increased the accuracy of taxpayers' tax returns. As a result, the Schedule K-1 program places taxpayers who receive flow-through income on a more equal footing with taxpayers who are wage earners.

Lead Development Center. IRS has adopted a strategy of identifying promoters of tax schemes as a key to halting their promotion and identifying those who have taken advantage of the scheme and thus likely owe taxes. The SB/SE division is currently developing plans and strategies for a Lead Development Center. The center's primary functions will be to develop case leads and assemble case information for distribution to compliance field offices for further investigation. Initially, the center will focus on abusive tax scheme promoters, and over time, it will expand to perform similar functions for fraud and anti-money laundering cases. The

center will also operate a computer laboratory that, among other things, is expected to monitor possible abusive promoter sites on the Internet. Specifically, the laboratory will support examiners in their case-development needs, including adequately capturing and documenting information from web sites in a manner suitable for introduction into evidence in a court proceeding. The center also will serve as a coordinating link among various IRS groups that deal with abusive tax scheme issues and with outside stakeholders such as DOJ, FTC, and others.

National Fraud Program

The National Fraud Program, which operates at IRS's campuses and field offices, coordinates efforts and provides oversight to IRS's compliance efforts to identify potential tax fraud. In addition, the program helps identify trends and disseminates the information within IRS and acts as a liaison on fraud cases involving bankruptcy and employment and excise taxes among other types of tax fraud. A National Fraud Program manager sets overall policy and program direction. Fraud managers are located in five area offices, and they oversee the activities of about 65 fraud referral specialists. These specialists assist other IRS revenue compliance staff in identifying cases with fraud potential, determining when indications of fraud are present, and developing potential cases. They also review fraud cases for technical accuracy and adequacy of supporting documentation to ensure appropriate and consistent application of fraud program guidelines and requirements. Cases where criminal activity is involved are referred to CI.

Recent and Continuing Efforts to Deal with the Challenges of Abusive Schemes

According to the Commissioner of Internal Revenue, illegal tax schemes place a major demand on IRS resources. A complex illegal offshore trust case could require several times as many hours as a typical exam, and thousands of these cases are emerging. IRS is now beginning to gather data that will better enable it to estimate the magnitude and nature of the offshore credit and debit card schemes. Improved data will help IRS identify how many and what types of resources it may need to address the schemes. However, the evasive nature of these schemes may necessitate face-to-face audits in a significant portion of cases to determine whether taxes are owed and the amount owed. Even if the number of individuals involved in these schemes is a fraction of the reported estimate of 1 to 2 million, IRS's staff may be challenged to audit them and maintain its current audit coverage as well. IRS's face-to-face audits have been declining, decreasing from nearly 400,000 in fiscal year 1999 to nearly 200,000 in fiscal year 2001.

Accordingly, IRS has begun considering whether other techniques than audits could be used to resolve these cases. For example, IRS is considering options such as disclosure initiatives, settlement initiatives, and self-correction programs. These techniques will need to be tested and refined to determine which, if any, are effective.

The increased scope of abusive tax schemes has also led IRS to

- develop an improved process for selecting the best cases to pursue among the many that it identifies,
- develop a new policy to govern simultaneous criminal and civil enforcement investigations of taxpayers,
- consider how to ensure that increased volumes of scheme-related tax assessments are followed up by IRS's collection function when taxpayers are unable to pay in full, and
- use its internal research group and a contractor to develop better models for identifying indicators that taxpayers may be participating in abusive tax schemes.

In addition, a significant organizational change has just been implemented in the SB/SE division that is intended to increase program oversight and coordinate programs and units dealing with abusive tax schemes and related tax fraud activities. To that end, in the past few weeks, the SB/SE division has divided its Office of Flow-Through Entities and Abusive Tax Schemes. Now, its efforts to ensure accurate reporting of income connected to flow-through entities will fall under a director for reporting compliance. IRS separated the flow-through entity effort from other abusive tax scheme efforts because it judged that the flow-through effort is more related to its traditional information-matching and examination programs than to its abusive scheme efforts. The flow-through effort will, however, also provide useful information for IRS to use elsewhere in investigations of abusive schemes.

The rest of IRS's SB/SE division's major programs and efforts that are more directly focused on abusive tax schemes—the National Fraud Program, the Abusive Tax Schemes Program, the Lead Development Center, and the Anti-Money Laundering Program—have been placed under a single executive for reporting enforcement. Monitoring the Internet and other media outlets where abusive tax schemes often are advertised will also be part of this centralized effort.

Criminal Investigation

IRS's Criminal Investigation (CI) investigates and pursues promoters and sellers of abusive schemes and the individuals using such schemes. CI's role is the enforcement of the tax laws for individuals who willfully fail to comply with their obligation to file and pay taxes and who ignore IRS's collection and compliance efforts. The most flagrant cases are recommended for criminal prosecution.

CI also administers the Questionable Refund Program that focuses on stopping the payment of various false tax refunds and, if warranted, on prosecuting the taxpayers involved. Furthermore, CI develops education and publicity activities warning taxpayers about abusive tax schemes and placed public information officers (PIO) in the field to specifically generate publicity regarding IRS's law enforcement efforts.

CI Enforcement Strategy

CI's enforcement strategy as it relates to fraudulent tax schemes is to focus primarily on the promoters of these schemes and on taxpayers who willfully use these schemes to evade taxes. For example, during a tax scheme investigation, CI generally attempts to gain access to a fraudulent promoter's list of clients to whom the promoter sold the scheme. In addition to pursuing the promoter, CI can then use the list of clients to determine who may have used the abusive scheme. CI determines which users of the abusive scheme merit investigation for possible prosecution and which users merit referral to IRS operating divisions for possible compliance and civil enforcement action.

Although CI has data on enforcement activity related to several types of tax scams (e.g., related to employment tax, refunds, return preparers, nonfilers, and domestic and foreign trusts), CI only separately tracked its promoter efforts for domestic and foreign trusts. (See table 1.) CI officials said that the number of full-time equivalent staff working on domestic and foreign trusts increased from 55 in fiscal year 1999 to 69 in fiscal year 2001.

Table 1: Summary of Domestic and Foreign Trust Cases from Fiscal Years 1999 through 2001

Cases	FY 1999	FY 2000	FY 2001
Active Investigations	131	126	165
(Promoters)	49	54	66
Prosecutions Recommended	57	44	30
(Promoters)	18	14	13
Indictments	35	53	32
(Promoters)	13	14	15
Convictions	24	31	45
(Promoters)	3	9	23

Note: Statistics in this table refer to individuals, such as indictments brought against 35 individuals in FY 1999.

Source: IRS's Criminal Investigation.

Although no consistent pattern exists across all of the categories in table 1, CI has had increases in the number of convictions obtained over the 3-year period. For purposes of deterring individuals from engaging in abusive trusts, the increasing numbers of convictions has provided IRS an opportunity to publicize more cases in which individuals have been found guilty. Furthermore, the increases in indictments and convictions of promoters may help deter promoter activity in particular.

Because the investigative and legal processes can span several years, data like those in table 1 do not show whether the cases investigated lead to prosecutions, convictions, or indictments in that same year. Furthermore, the data do not account for differences in the importance of cases, such as whether major fraudulent efforts are being successfully investigated and closed. IRS data do show that the average length of sentence for the abusive domestic and foreign trust program rose substantially from 35 months in 1999 to 64 months in 2001. To the extent that average length of sentence relates to the severity of the crime, IRS may be making headway in pursuing key abusive trust cases.

Questionable Refund Program

The Questionable Refund Program (QRP), administered by CI, was established in 1977. The QRP was designed to identify false returns, stop the payment of false refunds, and prosecute scheme perpetrators. Various false refund schemes are pursued under this program, including ones involving the earned income tax credit, the fuel tax credit, social security refund schemes, and slavery reparations. Questionable Refund Detection Teams (QRDT), located at IRS compliance service centers, conduct preliminary pre-refund reviews of questionable returns identified through

manual and computerized screening techniques. False return schemes meeting criminal prosecution criteria are referred to field offices for possible criminal investigation while returns with questionable civil issues are referred to the appropriate IRS compliance or collection group.

CI's Education and Publicity Efforts

CI's efforts also include informing and educating the public about abusive tax schemes and publicizing the results of its enforcement activities related to such schemes. CI has been particularly active in trying to disseminate information to the public to make them aware of IRS's activities and accomplishments in combating abusive tax schemes.[6] In addition, CI has PIOs located across the country who work with local media to publicize IRS's efforts and results.

CI Education and Publicity Activities. CI's education and publicity activities focus on warning taxpayers about fraudulent tax schemes so that they will not be tempted to use such schemes. CI hopes that increasing media coverage of successful tax scheme prosecutions will deter the public from participating in tax schemes because the perceived risk of detection, prosecution, and resulting penalties and sanctions will be too high. In addition, CI officials believe that publicizing the prosecutions of promoters and users of tax schemes helps assure the public that people are paying their fair share of taxes.

CI posted its web page (www.ustreas.gov/irs/ci) on the Internet in September 1997. According to CI officials, over the past 2 years, the Internet site has evolved into an important tool for educating and alerting the public about tax schemes and about CI's efforts to detect and deal with those who promote and use tax schemes. The Internet site provides

- fraud alerts warning the public of schemes where promoters are targeting unsuspecting taxpayers;
- information on topics including tax filing responsibilities, nonfilers, and abusive tax return preparers;
- summaries of cases and successful prosecutions of promoters and users of fraudulent schemes; and

[6] Other divisions within IRS also work to publicize IRS's activities related to abusive tax schemes. For example, SB/SE devotes part of its Internet site to fraud alerts and press releases.

- press releases and other IRS publications to generate a wide public distribution.

Tax practitioners also are targets of CI's publicity strategy. According to CI officials, some tax practitioners are using IRS's materials directly from the Internet site to inform those clients who may believe that a given tax scheme is legal. For example, clients may ask the tax practitioner to set up a fraudulent trust to reduce their taxes, and the tax practitioner can simply print the brochure about "Too Good to be True? – Trusts" from CI's Internet site to discourage the taxpayers from using such a trust.

In conjunction with using the Internet site as an informational tool to educate and warn the public of frivolous schemes, CI has taken steps to increase IRS's visibility and presence on the Internet. According to CI, it has recently intensified its efforts to improve the ranking of IRS's web page through the use of "metatags" or keyword tags. By doing so, IRS seeks to have Internet users who enter various terms in available Internet search engines find IRS's web page listed near the top of displayed search results. For example, CI is planning to add tags such as "pay no tax," and "form 1040" so that entering these terms will result in CI's Internet site being listed in the displayed search results.

CI is pursuing other possible strategies to ensure that CI's site rises to the top of Internet search responses. For example, CI staff has occasionally visited known promoter Internet sites to gather information on keywords used by those sites. IRS plans to incorporate those keyword tags into its Internet site. As a result, IRS expects to increase the odds that the CI Internet site would be included alongside Internet sites that promote questionable tax avoidance strategies. In addition, CI is working to create a web content manager position with responsibilities that include designing a strategy to maximize the potential of CI's Internet site. The manager would be responsible for helping to integrate CI data into the pages in IRS's Internet site that provide information to specific types of taxpayers.

CI Public Information Officers. In October 2000, CI established PIOs in each of IRS's 35 field offices. The PIOs serve as points of contact for all internal and external CI communications initiatives, including the issuing of press releases and the coordination of important law enforcement media events. Although IRS has other media relations specialists located in its field offices, their duties tend to focus on publicizing tax filing season information, including the benefits of electronic filing. CI PIOs

generate publicity specific to IRS's law enforcement activities, including the detection and prosecution of abusive tax schemes.

Primary functions of the PIOs include

- establishing contacts with editors, reporters, and news directors to educate them on tax issues and provide information about IRS and CI to enable them to write in-depth articles.
- encouraging media to include more stories on the detection and prosecution of abusive tax schemes.
- getting articles included in trade and professional journals and magazines that are read frequently by professionals such as doctors, lawyers, and accountants to make them aware of abusive tax schemes.
- developing a local media strategy. Part of CI's local strategy involves generating a "hook" to get the stories focused more on communities. In addition, CI has employed a strategy of "bundling" news stories. For example, CI has been working cases on fraud involved in the restaurant industry. Once several such cases have been put together, CI will bundle these stories together into a single news story for possible publication in magazines and journals read by people in the restaurant industry.
- giving speeches and participating in a wide variety of presentations, panel discussions, and conferences with professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the American Medical Association, to create public awareness of CI's activities and to provide information about fraudulent tax schemes.

IRS's Coordination with Other Relevant Federal Agencies

IRS works with various federal agencies in its efforts to identify and deal with fraudulent tax schemes. These include the FTC, the SEC, DOJ, FBI, and the United States Attorneys Offices (USAO).

In some cases, IRS's coordination is on an informal basis, as it is with the FTC and the SEC, and involves the sharing of certain information and detection techniques. In other cases, the relationship is more formal, as in the case with DOJ or USAOs, which prosecute fraud and other tax-related cases with the assistance of IRS staff.

IRS officials participate in various federal agency working groups, including a multiagency task force to share information, skills, and procedures for combating fraud on the Internet; an IRS and DOJ working group created to examine the use of civil injunctions against abusive promoters currently under criminal investigation; and a money-laundering-experts working group. According to the officials we interviewed, these working groups are invaluable for developing networking relationships between agencies, which facilitate information sharing among staff.

IRS staff also attends quarterly meetings with staff from the FTC, SEC, and DOJ to develop joint initiatives to combat Internet fraud. These meetings have spawned other activities for IRS staff, including FTC-sponsored training seminars and periodic visits to FTC's Internet laboratory to discuss strategies and share information and techniques to combat Internet fraud.

IRS also meets regularly with DOJ officials to discuss strategies for seeking injunctions and shutting down web sites that promote abusive tax schemes. According to a DOJ official, DOJ has received about 14 case referrals from IRS for injunctions in the past year or so. These cases have resulted in two permanent and two preliminary injunctions. The rest of the cases are in various stages of the judicial process. Furthermore, 10 of these 14 cases relate to the marketing of various types of abusive tax schemes and 4 involve shutting down web sites that promote abusive schemes.

Conclusions

IRS has long-standing programs and related efforts aimed at detecting and dealing with abusive tax schemes, particularly those related to frivolous tax returns and fraudulent tax refund claims. Recently, IRS has begun to take a more assertive and coordinated approach to detecting and dealing with an ever-changing array of abusive tax schemes, including those involving the use of domestic and offshore trusts. In the past year, IRS has added more resources to these efforts, created new programs, and improved others, and it is reorganizing its operations. Furthermore, based on the limited data available, IRS appears to be realizing some increased success in convicting those involved in schemes, publicizing these results, and uncovering previously hidden major offshore compliance problems.

Nevertheless, it is difficult to get a clear picture of all that is underway in IRS—how much is new as opposed to reemphasized or reorganized, and how the pieces combine to form a planned, coordinated effort with specific, defined outcomes. No central office, group, or executive could

provide us with an agencywide focus or perspective on IRS's strategy, goals, objectives, performance measures, or program results. Responsibility for the efforts was spread across various functions and groups within IRS. To some extent, this lack of clarity is not surprising given the fairly rapid and ongoing change in IRS's efforts, the expanding scope of the problem, and the difficulty in determining the difference between what is legitimate, aggressive tax planning and an abusive tax scheme.

IRS has recognized that its resources will be stretched to deal with these often complex schemes and that its multiple, enhanced efforts need to be better integrated. In an attempt to bring this integration to fruition, IRS's SB/SE division is reorganizing to place key efforts to combat abusive schemes under one executive. A centralized focal point should enhance IRS's ability to manage its efforts to reduce the prevalence and magnitude of abusive tax schemes.

Agency Comments and Our Evaluation

On May 16, 2002, we received written comments on a draft of this report from the Commissioner of Internal Revenue (see appendix). The commissioner agreed with the conclusions in the report.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Finance and the House Committee on Ways and Means and the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means. We are also sending copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. We will make copies available to others on request.

If you have any questions or would like additional information, please call me at (202) 512-9039 or Joseph Jozefczyk at (202) 512-9053. Key

contributors to this report are Marvin McGill, Jay Pelkofer, Grace Coleman, and Kathleen Seymour.

Sincerely yours,

Michael Brostek
Director, Tax Issues

Appendix: Comments from the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 16, 2002

Mr. Michael Brostek
Director, Tax Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Brostek:

I reviewed your draft report titled "Internal Revenue Service: Efforts to Identify and Combat Abusive Tax Schemes Have Increased, Challenges Remain (Job Code 440074)." Generally, the report is accurate and the statistical information included is correct.

Identifying and combating abusive tax schemes are among the highest compliance priorities within the IRS. We have begun to take a more assertive and coordinated approach to detecting and dealing with an ever-changing array of abusive tax schemes. In the past year, we have added more resources to these efforts, created new programs, and improved others.

I agree that integrating our efforts to combat abusive schemes under one SB/SE executive will strengthen our management control over our multiple, enhanced efforts to combat them. It will also enable us to more effectively use our limited resources.

If you have any questions, please contact Johnny C. Rose, Director, Operations Policy and Support, Criminal Investigation at (202) 622-4100.

Sincerely,

Bob Wenzel

Acting for Charles O. Rossotti

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